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FEDERAL COMMUNICATIONS COMMISSION
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Before the

FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
Rate Regulation	)	

COMMENTS OF CONTINENTAL CABLEVISION, INC.

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EXECUTIVE SUMMARY

The Commission's proposed cost of service valuation models suffer from many flaws, but the most significant is the failure to recognize the legitimacy of recovery of start-up losses, deferred returns, and unrealized economies which are presently either not reflected or carried as intangibles on the books of most cable companies. Cable is a still evolving, capital intensive industry. Since passage of the 1984 Cable Act, Continental Cablevision alone has invested more than $1.15 billion in system upgrades and improvements. It would be confiscatory for the Commission to set rates today that fail to reflect the true amounts invested in cable systems over the years.

To assist the Commission in establishing cable cost of service standards, Continental's comments present case studies demonstrating the financial dynamics of the cable industry. Ten-year financials for Continental's Brockton, Massachusetts system illustrate the basic characteristics of a cable system which has been built and held by an operator: investment in tangible physical assets is shown to reflect only a fraction of the capital invested in the system. The Brockton financials demonstrate that part of the investment consists of start-up losses incurred attracting subscribers to a business which requires intensive marketing over a period of years. Likewise, they demonstrate that part of the investment consists of the deferred returns due those investors who have endured start-up losses based on the legitimate expectation that later years earnings would produce a return for the entire period of the investment. These financial dynamics show why original cost, replacement cost and reproduction cost models fail adequately to compensate cable operators for real economic costs they have incurred in transforming hard assets into ongoing businesses.

Also presented is an internal 1986 venture analysis which documents how Continental bid for, acquired, and planned to upgrade four systems in and around Fresno, California. The then near record price Continental paid McClatchy Newspapers was based upon anticipated market growth which Continental hoped to achieve through system upgrades, remarketing, improvements in customer service and programming, and consolidation with its other Northern California operations. Continental documents how it succeeded, thus more than justifying the purchase price. Nonetheless, for accounting purposes, about one-third of the $127 million purchase price was assigned to the very intangibles which the Commission has proposed to disallow as an "acquisition premium." This case study demonstrates clearly why intangibles should be included in the rate base.

Acquired properties' intangibles should be presumed to reflect the price paid to compensate the seller for start-up losses, deferred returns and the value of a going concern. Such a presumption should not be regarded as any form of excess acquisition premium. Continental presents evidence showing that businesses which the Commission itself treats as competitive or nondominant regularly sell at purchase prices far in excess of net book value. The same is true for regulated telephone companies, even after regulation has curbed market power. Cable assets being brought into regulation need to have a one-time transitional adjustment to assign the fair value to the rate base. Such an adjustment is required to serve the constitutional requirement of providing an opportunity to earn a fair return on invested capital. It is comparable to the treatment which the Commission afforded Comsat, to the treatment afforded electric utilities for Allowance for Funds Used During Construction and for telephone with respect to Plant Under Construction.

The appropriate rate of return should begin with recognizing the characteristics of cable which make it far riskier than telephone or established businesses like the S&P 400. That risk is evident from objective sources: the relative volatility of cable stocks compared with telephone stocks; the comparative spread against risk-free treasury bonds for telephone versus cable debt issues; the relative penetration of cable versus other consumer goods and services. Continental shows that the covenants of typical cable debt issues contain restrictions (and an objective investor assessment of risk) which are foreign to telephone issues.

Continental explains why neither discounted cash flow nor investment cycle approaches are workable for an industry that has no dividend history and that cannot be guaranteed a future return. Therefore, Continental recommends that the Commission use a modified risk premium approach to establish the appropriate rate of return, based on the average interest spread for cable debt relative to telco debt and the capital costs of comparable firms, adjusted for the substantially higher cable industry risk and volatility.

Continental's comments address other areas of concern and offer specific recommendations. Construction work in progress should be included in rate base even if work will occur over more than one year. With this rule, an historical test year, with pro forma adjustments for known and measureable changes, may be utilized.

Cable operators should be permitted to average costs at higher accounting levels than the system or franchise, in order to account for consolidation of systems, and to provide more administratively efficient rate filings. Costs need not be allocated strictly by channel, which will have distorting effects restraining advances in digital compression and the provision of specialized new services to consumers. In these early years, the Commission should retain the flexibility to accept various allocations, such as channels weighted by household penetration, and 6 MHz channel equivalents.

The Commission should not condition the filing of cost of service cases on the pursuit of cost of service rates at all jurisdictional levels. Continental believes that any concern over excess returns can be addressed by requiring an operator to demonstrate the reasonableness of its overall return from both basic and cable programming service tiers.

Given the rapid technological changes in cable television, the complexities of prescribing depreciation rates and the absence of any statutory directive to regulate depreciation, the Commission should do no more than monitor cable depreciation practices to deter manipulation.

The Commission's proposals to streamline both benchmark and cost of service regulation are sensible and should be implemented wherever they are feasible. Streamlined approaches should include an adjustment to benchmarks for addressability and for exogenous costs, and a right to average equipment costs across regions.

Rate increases should be permitted in one year cycles commencing no sooner than the first anniversary of an operator's last rate increase.

The Commission can, consistent with its Cable Act obligations, provide for recovery of invested capital and reasonable return on assets by first comparing and contrasting the cable industry to the more traditionally regulated common carriers. If it does so the Commission will find that the cable business is subject to far greater investment risks than established local exchange carriers. Distinctions will show that rote application of traditional common carrier regulatory precepts will not provide the cable industry with reasonable rates nor provide consumers with the benefits of new programming services and technological enhancements. Adopting the proposals outlined herein will streamline the regulatory process and facilitate cable's transition into regulation.

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Rate Regulation	)	

COMMENTS OF CONTINENTAL CABLEVISION, INC.

Continental Cablevision, Inc. ("Continental") hereby submits these comments on the July 15, 1993 NPRM concerning cost-of-service requirements.

Continental is the third largest multiple cable system operator in the United States. It serves nearly 2.9 million basic subscribers in 600 communities in 16 states, or approximately 5.5 percent of the nation's cable television households.

I. INTRODUCTION

The Commission's recent Notice of Proposed Rulemaking seeks comment on the establishment of rules to govern cost-of-service showings by cable operators who seek to justify rates above the benchmarks previously adopted by the Commission. In the NPRM the Commission seeks comment on:

- Proper regulatory goals and policies to guide the establishment of cost-of-service standards;

- Methods to calculate and arrive at a reasonable ratebase;
- Methods to determine a reasonable rate of return, perhaps to be reduced by a productivity offset;
- Treatment of various expense items associated with providing cable service;
- Uniform accounting and cost allocation requirements and depreciation prescriptions;
- Suggested streamlined alternatives.

In these comments, Continental will address each of these issues in detail and propose methods and procedures to properly allow cable operators to recover the costs of providing service while protecting consumers from unreasonable rates. Continental has exhaustively examined its own operations and commissioned research of the relevant economic issues and precedent. To that end, Continental includes with its comments a study by its economic consultant, Economics and Technology, Inc. ("ETI"), and analyses by the investment banking firm, Morgan Stanley and Co., Inc., and Continental's senior management.

Taken together, these studies and analyses demonstrate that traditional common carrier regulation is inappropriate for cable television system operators. The Commission itself recognized that, consistent with Congressional guidance, cost of service requirements for cable rates "will not replicate Title II regulation."[1/] The Commission developed varied and complex

1/ NPRM ¶ 15 at n.16; see House Report 102-628 at 83.

procedural and substantive rules over the many years of rate regulation for communications common carriers. Rote application of these rules to cable operators, however, would disserve the policies of the 1992 Cable Act by unduly restricting and complicating cable operators' operations without any corresponding benefit to subscribers, except perhaps short-run low (but confiscatory) rates.

II. CONSTITUTIONAL REQUIREMENTS OF RATE REGULATION

General constitutional principles of rate regulation have been often repeated.[2/] The FCC has placed considerable reliance on periodic pronouncements that if the total effect of the rates imposed are not unreasonable then the method or methods utilized in arriving at those rates is constitutionally sound.[3/]

2/ The United States Supreme Court long has held that a rate set by a regulatory agency is too low if it is "so unjust as to destroy the value of [the] property for all the purposes for which it was acquired", and and in so doing, "practically deprive[s] the owner of property without due process of law." Covington & Lexington Turnpike Road Co. v. Sanford, 164 U.S. 578, 597 (1896); see Duquesne Light Co. v. Barasch, 488 U.S. 299, 307-08 (1989). The Court, moreover, has stated that "[b]y long standing usage in the field of rate regulation the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." F.P.C. v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942). Accordingly, if a "rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth . . . Amendment[]." Duquesne Light Co., 488 U.S. at 308.

3/ See Natural Gas Pipeline Co., 315 U.S. at 586.

Yet recognizing that this simple result-oriented tautology cannot survive alone, the Supreme Court has counselled a more cautious approach. This precept,

> of course, does not dispense with all of the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is so low as to be confiscatory: whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting system, and on the amount of capital upon which the investors are entitled to earn that return. At the margins, these questions have constitutional overtones.

Duquesne Light Co., 488 U.S. at 310.

The Court has repeatedly held that no single rate theory is constitutionally required and that to eliminate other theories for determining reasonableness of rates would itself be constitutionally infirm.[4/] Several crucial consequences flow from that holding.

4/ "The adoption of a single theory of valuation as a constitutional requirement would be inconsistent with the view of the Constitution this Court has taken . . . The designation of single theory of rate making as a constitutional requirement would unnecessarily foreclose alternatives which could benefit both consumers and investors. Duquesne Light Co., 488 U.S. at 316 (citation and footnote omitted).

A. Cable Rate Regulation Cannot Be Artificially Linked to Benchmarks

First, a result-oriented effort to mirror the output of benchmarks is constitutionally defective. The Commission's choice of benchmarks was derived from pricing of cable services in a relatively small number of overbuild and low penetration markets. As such, the benchmarks do not reflect cost-causative factors driving cable system operations. Establishing cost of service standards intended merely to match the outcome of benchmarks will not provide constitutional protection and will merely perpetuate the shortcomings in the benchmarks which themselves necessitate an alternative means to cost recovery.[5/]

The Commission is constitutionally required to provide an opportunity for a rate regulated cable operator to show that the benchmark pricing system does not permit a fair return on the costs incurred and capital committed for the operation of the cable system. No specific benchmark could accurately reflect cost elements, except by pure chance.

5/ Neither the 1992 Cable Act nor the benchmarks are predicated on any evidence of cost. Instead, they are premised on an untested assumption that businesses operating in the overbuild and low penetration markets sampled were earning a reasonable return on investment, despite overwhelming evidence to the contrary, including the financial failure of some of the very systems assumed to be in equilibrium.

B. Cable Rates Cannot Be Artificially Tilted Against the Interests of Investors

Second, the Commission may not constitutionally disregard the legitimate interests of investors and the peculiar differences between cable television and telephone finance and accounting. Accordingly, the methods chosen must accommodate the unique circumstances of the industry subject to regulation, but the ultimate evaluation of the impact of the rate must depend on the return investors expect given the risk of the enterprise.[6/] While Congress did direct that in setting rates the Commission should evaluate consumer interests, the Constitution mandates more; it requires consideration of the investors _and_ the regulated entity's interests.[7/] Congress cannot direct an agency to ignore the balance or tip it in favor of consumer interests.

6/ Rates must afford the utility the ability to operate successfully, maintain its financial integrity, attract capital, and compensate its investors for risks assumed in the undertaking. _FPC v. Hope Natural Gas Co._, 320 U.S. 591, 603 (1944). Utility investors must receive a return "equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are tended by corresponding risks and uncertainties." _Bluefield Water Works and Improvement Co. v. Public Serv. Comm'n_, 262 U.S. 679, 692-93 (1923). _See also Hope_, 320 U.S. at 603.

7/ "Thus, there is a zone of reasonableness within which rates may properly fall. It is bounded at one end by the investor interest against confiscation and at the other by the consumer interest against exorbitant rates." _Washington Gas Light Co. v. Baker_, 188 F.2d 11, 15 (D.C. Cir. 1950), _cert. denied_, 340 U.S. 952 (1951).

C. Cable Rates Must Account For the Transition of Assets In and Out of Rate Regulation

Third, the Commission must account for the peculiar transition in which the industry and regulators have been placed by the 1992 Act. The Act imposes sweeping new rate regulation mandates on an industry which was largely rate deregulated between 1984 and 1993. At the same time, the Act envisions rate regulation itself as a transition to a competitive market which much of the Act, and the actions of the Commission, are designed to promote. The Commission has already noted that other regulatory agencies have adopted interim measures "balancing consumer and regulated company interests" to facilitate important changes in the manner in which the industry is regulated. NPRM at 13 n.21. The Commission specifically cited a 1992 Order of the Federal Energy Regulatory Commission ("FERC"), in which that agency adopted certain interim transitional measures, including permission to renegotiate and cancel contracts to expedite transition into the new regulatory environment.[8/] In that order,

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8/ See Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 F.R. 13,267, 13,304 (F.E.R.C. Apr. 16, 1992). A number of other tribunals have recognized the need for intelligently crafted measures to ease transitions into new regulatory environments. See, e.g., Farmers Union Central Exchange, Inc. v. F.E.R.C., 734 F.2d 1486, 1517-18 (D.C. Cir. 1984), cert. denied, 469 U.S. 1034 (1984); Order Instituting Investigation Into Rate Design For Unbundled Gas Utility Services, 109 P.U.R. 4th 165 (Cal. P.U.C. 1987)

[Footnote cont'd.]

the FERC also recognized that the sweeping industry changes produced by the new regulatory environment imposed additional costs on the regulated businesses, and that gas pipelines needed to recover those costs. 57 F.R. at 13,307. Cable operators, who are being swept from deregulation to reregulation and transitioned to open competition, must likewise be afforded reasonable transitional measures to assure cost recovery and appropriate returns.

In fashioning its cost of service rules to account for this transition, the Commission should review how courts struggled with rate regulation in the early days when industries in their infancy were being first subject to regulation. In these early days of regulation courts expressly allowed considerations of "fair value" to guide the setting of rates. For more than fifty years the rule of Smyth v. Ames specified the criteria to determine reasonableness of rates.

[Footnote cont'd.]

(synopsis, full text unpublished) (transition costs incurred on behalf of ratepayers to be recovered from ratepayers); Petition of Southwestern Bell Tel., Inc., 1986 Tex. P.U.C. LEXIS 111, *72 (1986) (acknowledging that post-transfer retention of pre-transfer private line rate structure necessary for transition to a new rate structure).

> [T]he basis of all calculations as to the reasonableness of rates...must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case.

Smyth v. Ames, 169 U.S. 466, 546-47 (1898). This pronouncement was the law of rate regulation for almost fifty years until the Supreme Court held that "fair value" was not the only constitutionally acceptable method of fixing utility rates. In Hope, the Court found that historical cost was also a valid basis in which to calculate utility compensation. Hope, 320 U.S. at 605. Until Hope, the Court uniformly found fair value and utilized going concern value and valued other intangibles in determining reasonable rates.[9/]

However, approximately half way through the life of Smyth v. Ames, Justice Brandeis, in a remarkable and celebrated concurrence in Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 292-94 (1923),[10/] argued that

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9/ See, e.g., Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287, 313 (1933).

10/ Justice Brandeis' opinion is often characterized as a "dissent" because he differed "fundamentally from [his]

[Footnote cont'd.]

the amount of "prudent investment" better reflected the measure of the compensatory rate necessary to survive constitutional review. Justice Brandeis nonetheless recognized that goodwill, franchise value and other intangibles have value in condemnation cases (and indeed are often more valuable than tangible property), but believed that there were too many practical problems associated with "the laborious and baffling task of finding the present value of the utility." Id. at 292-94.[11/]

Although Justice Brandeis essentially accepted the "eminent domain" analogy to determine values, he focused more on prudent investment as the appropriate measure than the value of the assets or business. While the logic of Justice Brandeis' concurrence in the Southwestern Bell decision arguably led -- twenty years later -- to the abandonment of the "fair value" concept as the only means of evaluating utility rates, the unique circumstances of the cable industry create a situation where fair value is an appropriate consideration in determining whether cable operators' rates are indeed reasonable.

[Footnote cont'd.]

bretheren concerning the rule to be applied in determining whether a prescribed rate is confiscatory." Id. at 289.

11/ The major problem with "fair value" was the impossibility of determining market prices because utility assets were rarely bought and sold. Duquesne Light Co., 488 U.S. at 309. However, cable systems in the 1980's, not being regulated utilities were routinely bought and sold in a competitive market, thus providing an accurate basis for determining "fair value."

Historically, "fair value" was an important concept when the regulation of an industry was in its infancy, and is important to the cable industry given its current state and movement into regulation. The importance of fair value considerations in the time before Hope was exemplified in the Court of Appeals' decision reversed by the Supreme Court in that case. In that decision, the court noted that the "newness" of the industry, uncertainty of customers and business as well as the difficult engineering problems all were relevant considerations requiring an analysis of more than the costs committed to the tangible assets.

> The losses of the first years supplied persuasive evidence that the investment was highly speculative and an adequate return on the capital invested depended largely upon the business acumen, the engineering skill, and administrative efficiency of their officers, to overcome these losses and develop a profit in this newly regulated industry. Under such circumstances it seems that fairness necessitates the capitalization and inclusion of such skill -- aye, and hazards . . . as legitimately as the cost of pipes . . . It was the courage of the investors, and their willingness to take a chance in a speculative venture, the vision to see and to forecast, the integrity of management . . . which gave to the enterprise its life; and the product of these combined factors made for a going value, which, in the realities of the business world, is justly recognized as part of the value of the investment. It is the existing fact situation peculiar to this case which calls loudly for the inclusion of a sum for going value, as such. Nor can we fairly apply the law, save as we first study the facts and get the proper setting of the natural gas industry in the utility field.

Natural Gas Pipeline Co. v. F.P.C., 120 F.2d 625, 635 (7th Cir. 1941) (emphasis added), rev'd, F.P.C. v. Natural Gas Pipeline Co. 315 U.S. 575 (1942).

Indeed, "fair value" had been the only way to fairly assess the capital committed to the operation of the enterprise. Even Justice Brandeis recognized that in the early stages of regulation for an industry, concepts such as "original cost," "capital charges" and the like were difficult to determine in assessing the adequacy of rates.

> Twenty-five years ago, when Smyth v. Ames was decided, it was impossible to ascertain with accuracy, in respect to most of the utilities, in most of the states in which rate controversies arose, what it cost in money to establish the utility, or what the money cost with which the utility established, or what income had been earned by it, or how the income had been expended. It was therefore, not feasible then to adopt, as the rate base, the amount properly invested, or, as the rate of fair return, the amount of the capital charge.

Southwestern Bell, 262 U.S. at 309.

Upon maturity, the rules of regulatory ratesetting changed to reflect advances in accounting and development of the regulated industries. The cable industry now, however, reflects many of the problems noted by Justice Brandeis at the advent of regulation, especially the difficulty of determining "original cost," and deciphering, through various layers of financing and acquisitions, what the actual costs and capital investment are, or even the value of the assets acquired or constructed initially.[12/] Courts have always noted that depreciated book value of assets in no way reflects a "fair value" by itself.[13/] Indeed, the "fair value" of even long-regulated utilities typically exceeds book value by a significant factor. See Part IV.C.2. Moreover, the D.C. Circuit has recognized that the central goal of utility rate regulation is the protection of invested capital, not merely particular items of property.

> Justice Brandeis' formula for ascertaining rate base -- the amount of capital prudently invested -- was not to become the prevailing rule. But what has since prevailed is the central idea that the investor's legally protected interest resides in the capital he invests in the utility rather than in the items of property which that capital purchases for provision of utility service.

Democratic Central Committee v. Washington Metropolitan Area Transit Co., 485 F.2d 786, 801 (D.C. Cir. 1973), cert. denied, 415 U.S. 935 (1974).

12/ Cable operators have utilized differing allocation methods and have expensed many items rather than capitalized them, resulting in an artificially low rate base. See Part IV.B.

13/ "Good-will and going concern value may have great value and yet not be reflected by the books at all. The same is true of easements, water rights, patents and similar intangible property rights. But their inclusion in the book accounts at a certain value is little, if any evidence of their true value, and their omission from the books does not estop the owner from claiming that which actually exists." Eastbay Water Co. v. McLaughlin, 24 F. Supp. 222, 227 (N.D. Cal. 1938).

While reviewing Courts generally have been deferential to agencies' ratemaking metholodogies,[14/] there recently has been some willingness of courts reviewing agency rate determinations to overturn those determinations where an unreasonable result ensues from the agency's rate-setting methodology.[15/] In order to avoid the unnecessary collision between the developing industry and the 1992 Cable Act, the Commission must allow for transition in ratesetting to reflect expenses incurred in prior years and assets bought and paid for prior to regulation.

III. THE UNDERLYING FINANCIAL MODEL FOR CABLE TELEVISION

Continental submits that fashioning appropriate cost of service rules cannot begin with reflexive resort to telephone models, but must begin with an understanding of financial decisionmaking in cable television.

14/ See John N. Drobak, From Turnpike to Nuclear Power: The Constitutional Limits on Utility Rate Regulation, 65 B.U. L.Rev. 65 (1985); Richard J. Pierce, Jr., Public Utility Regulatory Takings: Should the Judiciary Attempt to Police the Political Institutions?, 77 Geo. L.J. 2031 (1989) ("Pierce").

15/ See, e.g., Jersey Central Power & Light Co. v. F.E.R.C., 810 F.2d 1168 (D.C. Cir. 1987) (court invalidation of FERC order excluding from electric utility's rate base certain costs associated with cancelled nuclear power project). See Pierce, 77 Geo. L. Rev. at 2033-39 (United States Supreme Court and other federal courts have "already begun the process of imposing rigorous constraints on ratemaking").

A. Sources and Uses of Funds

Financial decisionmaking in the cable television industry, like most industries, is generally made on the basis of a "sources and uses of funds" paradigm. Under this paradigm, the subject venture's cash flows are analyzed and projected in a detailed manner, particularly as to the various components of operating revenues (basic subscribers, pay tv units, rates, number of additional outlets, etc.) and operating expenses (operating, general administrative and programming, etc.).[16/] From these, a projected operating income figure is derived, then plugged into a formatted sources and uses analysis where

Sources = Operating Income
Terminal Value

and

Uses = Capital expenditures, expenses, and Taxes

The terminal value is equal to the present value of the future streams of income beyond the horizon of the analysis. For example, if the analysis runs from year one through year seven, a terminal value in year seven would be a function of the cash flows expected from years eight through infinity. Alternatively,

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16/ This assumes that the analysis will be performed without regard to the debt-equity mix. Otherwise, sources would include financing (i.e., proceeds of debt) and uses would include debt service (i.e., interest and amortization).